February 7, 2007

Testimony of

Brad Setser
Fellow, Geoeconomics
Council on Foreign Relations[1]

Before the
US-China Economic and Security Review Commission

"The Implications of Sovereign Wealth Fund Investments for National Security"

[1] The Council on Foreign Relations takes no institutional position on policy issues. All statements of fact and expressions of opinion contained in this publication are the sole responsibility of the author

I would like to thank Chairman Wortzel, Commissioner Mulloy and the members of the US-China Economic and Security Review Commission for the opportunity to testify today.

The sudden prominence of sovereign wealth funds stems from the combination of high oil prices and extensive exchange rate management in Asia – along with the adoption of investment strategies that have raised the public profile of many long-established funds.

Today's global economy is marked by large current account surpluses in the major oil-exporting regions and an equally large surplus in East Asia even though Asia is a major oil-importing. The simultaneous presence of large surpluses in both Asia and the oil-exporters differentiates the current era from the late 70s. These large current account surpluses financed a large buildup of the foreign assets of their respective governments, not private capital outflows. Former Assistant Secretary of the Treasury Edwin Truman noted that recent developments have "shift[ed] wealth toward countries with different conceptions of the rule of government in their economic and financial systems" than the United States.

Until recently, the most of those assets have been held as central bank reserves and invested conservatively. The scale of global reserve growth is truly stunning – full data is not yet available for 2007, but the total increase in their reserves is likely to top $1200b.[2] The lack of transparency from many sovereign funds makes a precise accounting of their growth far harder, but it is likely that they added nearly $200b to their assets. If government asset growth remains at its current pace and more of those assets are managed by sovereign wealth funds – as is now widely anticipated by many investment banks – the pace of growth of sovereigns funds will increase dramatically.

These global trends apply with particular force to China. China's government is now adding at least $500b a year to its foreign assets, and perhaps up to $600b.[3] Right now, China's sovereign wealth fund – the China Investment Corporation (CIC) – manages a relatively small share of the total stock of Chinese investment abroad. It is likely to account for a large share going forward.

My remarks will be organized in two parts. The first will examine the forces that have propelled the growth of sovereign funds and the differences among sovereign funds. The second will examine the particular issues raised by China's investment corporation,

---

[2] This total has been adjusted to reflect valuation gains on central banks holdings of euros, pounds and yen. It also includes funds managed by the Chinese banks as a result of the use of foreign exchange reserves to finance their recapitalization and the non-reserve assets of the Saudi Monetary Agency. The unadjusted increase reported by the IMF from the end of q3 2006 to the end of q3 2007 was ; all indications suggest that q4 was marked by strong reserve growth. Japan accounts for about $50b of the global total; the rest comes from the emerging world.

[3] There is substantial uncertainty over the scale of the increase in the foreign assets of the Chinese state banks in the second half of 2007. It has been widely reported that the state banks were asked to hold foreign exchange to meet the recent series of increases in their mandatory reserves. This could potentially have led to the accumulation of roughly $100b of foreign exchange by the large state banks.

and, more generally the increase in the non-reserve foreign assets of China's government. The availability of large quantities of foreign exchange to finance the outward expansion of Chinese state firms is likely to raise far more difficult issues than the CIC.

Sovereign wealth funds

Origins of sovereign funds

Sovereign wealth funds typically originate in one of three ways:

- The government sets up a fund to manage the fiscal surplus from a surge in commodity export revenues. These funds are typically held in foreign currency to facilitate domestic economic management and consequently are invested abroad. Examples of such funds include: Abu Dhabi Investment Authority, Kuwait Investment Authority, Qatar Investment Authority, Norway's Government Fund -- Global as well as smaller funds like Kazakhstan's National Fund, Russia's new future fund (its bigger oil stabilization fund is managed as part of the central banks' reserves) and Chile's copper fund. Subnational funds like Alberta's Heritage Fund and Alaska's Permanent Fund are in some ways similar, though they tend to have more domestic and fewer foreign assets.
- The government sets up a fund to manage a portion of the country's foreign exchange reserves more aggressively.[4] Such funds are a by product of efforts to manage the exchange rate, and are usually are set up when the government's total holdings of foreign exchange reserves exceed what conceivably could be needed for prudential reasons. Examples include Singapore's Government Investment Corporation, the Korea Investment Corporation and the China Investment Corporation.
- A government fund set up to manage the government's investment in its own state owned enterprises decides to diversify and expand abroad. Examples include Singapore's Temasek and, to a lesser, degree, Dubai World and Dubai Holding.[5]

Government pension funds – which collect the retirement contributions of either government employees or a funded national pension system – are similar, but distinct. They are managed to deliver benefits to a defined set of beneficiaries, and typically have large domestic rather than large international portfolios. However, many are diversifying their portfolios and adding international investments. The line between a pension fund and a sovereign fund though is often blurred: Norway's government fund is intended to provide revenue to Norway's government once Norway's oil is exhausted, revenue that will help Norway meet its pension obligations. Singapore's GIC manages money for Singapore's retirement system as well as for its central bank. Korea's KIC is seeking money from Korean pension funds.

[4] In some cases, the finance ministry rather than the central bank effectively raises the funds for intervention in the foreign exchange market, in theory reducing the central bank's need to sterilize.
[5] Dubai [World] manages the assets of the government of Dubai; Dubai [Holding] manages the private holdings of the ruler of Dubai.

Differences among sovereign funds

While sovereign funds all manage money for governments, the differences among sovereign funds are far more striking than their similarities. This reflects the diverse set of governments that have large funds: Norway – a transparent democracy that was already wealthy before North Sea oil – is very different from either the Gulf or China. It also reflects differences in the investment styles of different funds: some funds have conservatively portfolios that resemble the portfolio of a central bank, others have portfolios that resemble the portfolio of a large American or European pension fund, and still others increasingly resemble private equity or hedge funds. Some shy away from taking large stakes in companies, seeking a high level of diversification. Others make concentrated bets on a few companies. And some funds that traditionally have steered clear of large, visible stakes have recently changed course and provided large amounts of financing to troubled US banks and broker-dealers. The total capital injections into major US and European banks and broker-dealers over the past several months – roughly $42b[6] – now exceeds the peak annual increase in IMF lending to the emerging world during the Asian and Russian crisis of 97/98 or the Latin and Turkey crisis of 01/02 .

Sovereign funds can consequently be differentiated by:

Mandate and investment style. Some funds have as a goal promoting local economic development, or supporting the outward expansion of national firms. Others are pure money managers. Some seek to essentially replicate the returns on a broad index and/ or outsource the management of most of their funds; others manage more funds in house and/ or take large stakes in individual companies. Some use leverage to enhance returns; most do not – at least not directly. Many invest in hedge funds and private equity that are leveraged.

Transparency. Some funds reveal more information than a typical central bank – and far more information than a private equity and hedge funds. Other funds have refused to disclose their total size, let alone the broad contours of their portfolio.

Size. A $700b fund – a reasonably estimate for Adu Dhabi Investment authority – raises different questions than a $10b fund. A fund growing by a $100b or more a year raises different issues than a fund looking to invest a billion dollars a year. A fund growing by $500b a year would raise even more concerns.

Wealth of the host country. A sovereign fund from a country with a per capita GDP – at PPP exchange rates – of $5,000 will likely be motivated far more by the desire to support national economic development than a sovereign fund from a country with a per capita GDP of $50,000.

Geopolitics. Funds from small city states allied with the United States are likely to generate fewer concerns than funds from countries with aspirations to be global or regional powers.

Not all sovereign funds raise the same issues. A transparent fund from a small country, accountable to a parliament that sets basic parameters for its investments is likely to pose

[6] This total excludes ICBC's investment in Standard Bank, CDB's stake in Barclays and the reciprocal Bear/ CITIC stake on the grounds that none of these deals provided capital to offset "subprime" losses.

few risks, particularly if it holds a portfolio that generally tracks a broad index. Norway, for example, recently decided to increase the share of its government fund that is invested in equities. Before it actually adjusted its portfolio, though, it obtained parliamentary approval – and the pace of the adjustment in its portfolio can be monitored using the data Norway releases. It is unlikely to surprise the market with a sudden move.

The activities of larger funds will raise more concerns, simply because their size will augment their market impact. Large, less transparent funds that take larger financial risks, including large investments in troubled financial institutions will raise more concerns, though it is isn't clear whether the citizens of the country doing the investment or the country receiving the investment should be more worried. A large fund with a mandate both to invest abroad to obtain higher returns and to support the outward expansion of national firms will raise far more concerns that its investments – even investments driven entirely by a desire for returns – are motivated by non-commercial considerations than a fund that only manages an investment portfolio.

The China Investment Corporation

The China Investment Corporation (CIC) raises a particularly vexing set of issues, both for China and for the countries that will receive its investment.

The activities of a fund from a large country like China are bound to receive more scrutiny than the activities of a smaller fund, simply because of China's greater capacity to impact markets. While the CIC itself is still small, the overall accumulation of foreign assets by China's government is not. The increase in the foreign assets of China's government in 2007 almost certainly topped the increase in the foreign assets of all the world's oil-exporting economies combined.

Moreover, China's fund is unlikely to resemble the funds of other countries, largely because China itself is a very different country from the other countries that have large funds. It is unlikely to resemble the transparent fund of a socially democratic country like Norway. Norway's fund is accountable to a democratically elected parliament; China's fund is accountable to China's State Council. It is unlikely to resemble the sovereign funds of the small Gulf countries, which tend to resemble the family offices of a very wealthy family more than public pension funds. It is unlikely to resemble Singapore's funds – even though the CIC was modeled on Singapore's GIC more than any other fund – simply because China is both a much poorer and much bigger country than Singapore.

Five characteristics combine to set the CIC apart from other funds:

a) The CIC is financed by the issuance of debt, not from a fiscal surplus. The CIC is structured as an asset manager for the Ministry of Finance (though it reports to the State Council, not the Finance ministry) which issues bonds to buy the foreign exchange that the CIC manages. However, the CIC is fundamentally a financial intermediary; it needs to generate enough income to cover the interest payments on the Ministry of Finance bonds issued to fund it.

b) The CIC, which above serves to support China's efforts to limit the pace of RMB appreciation, is required to take on an exceptional level of exchange rate risk. The market currently expects the RMB to appreciate by 8% a year against both the dollar and euro. The bonds issued to finance the CIC carry a 4.5% interest rate. That implies that the CIC needs a return of around 13%, net of fees and expenses, just to break even in RMB terms. Unusually among investment funds, it is more likely to produce losses than gains. It arguably is unfair to expect the CIC to overcome the headwind created by RMB appreciation, as it was created to try to achieve a higher dollar and euro return on the dollars and euros China needs to accumulate to support its exchange rate regime. But the prospect of losses, in RMB terms, at a minimum poses a public relations challenge: as James Fallows of the Atlantic noted in a recent article, China's public has taken a strong interest in its financial performance.

c) The CIC has a complex mandate that extends well beyond simply increasing the returns on China's foreign assets. Prior to the formation of the CIC, different parts of China's government came forward with proposals to make more creative use of China's vast foreign exchange holdings. The CIC that emerged from this process is a synthesis of different ideas. Its mandate includes managing China's investment in its domestic state banks, supporting the outward expansion of Chinese firms and managing China's external investments in a portfolio that will include more equities than in China's reserve portfolio. Right now, though, the CIC's domestic portfolio is far larger than foreign portfolio.

d) China is a far poorer country than the other countries with large investment funds. The average per capita income of the countries that currently host the five largest funds is over $50,000 (PPP); China's per capita income is still only around $5,000 in PPP terms, and less at market exchange rates. As a result, the CIC will likely face stronger pressure to find ways to support China's own economic development than funds from wealthier countries.

e) The CIC's potential size. Right now, the CIC's external portfolio is quite small. It had invested – by my estimate – only about $17b abroad by the end of 2007, a sum that should increase to around $60b over the next several months. Most of its initial RMB 1.55 trillion (roughly $205b) allocation has been used to purchase the central banks' existing stake in three large state banks and to recapitalize two other banks. However, the scale of the China's overall foreign asset growth suggests that the CIC could quickly become one of the world's largest funds, it not the largest funds. No other government is adding $500b to its foreign assets a year. Indeed, if the foreign assets of the Chinese banks that the CIC owns are added to its external portfolio, the CIC already in some sense controls a $300b portfolio – enough to put it among the world's largest funds.

The CIC itself is under incredible pressure. Its first high-profile international investment – Blackstone -- lost money. It faces tremendous pressure not to make a similar mistake, yet it also faces pressure to invest quickly and generate strong returns. However, it could easily fail to produce sufficient dollar and euro returns to offset RMB appreciation (dollar/ euro depreciation). While the investments of SAFE are veiled in obscurity, every CIC move is closely scrutinized at home and abroad. Its autonomy is constrained: large investments likely need the approval of the top level of China's government. Press reports – and the decision to block the China Development Bank's investment in Citibank – suggests that China's top leadership is worried that the CIC's portfolio is too concentrated in the financial sector.

The rest of China's government is not necessarily vested in the CIC's success. The bureaucratic rivalry between China's finance ministry and central bank has spilled over into rivalry between the CIC – linked to the Finance Ministry – and China's existing foreign exchange manager – the State Administration of Foreign Exchange (SAFE). SAFE is keen to prove that it can deliver better returns than the CIC at a lower cost if it is given more freedom to take risks. Coordination is likely to be an ongoing challenge. The parts of China's government with links to the state firms want the CIC to do more to support their outward expansion, including the outward expansion of China's mining companies. Overtly supporting Chinese state firms would contradict the assurances the CIC has given to the US and Europe that it is motivated solely commercial considerations of risk and return. Not supporting Chinese state firms though risks the creation of a new bureaucratic rival.

The creation of the CIC, and, more generally China's desire to shift from a portfolio concentrated in government bonds and other classic reserve assets toward a more balanced portfolio poses a host of issues for the US and Europe. So long as China manages its currency against the dollar, it is likely to face pressure to keep the majority of its foreign assets in dollars. Large scale selling of the dollar for say euros would likely put pressure on the dollar/ euro exchange rate (Europeans have supposedly asked China not to diversify its reserves for precisely this reason; they do not want an even stronger euro). The scale of China's foreign asset growth though implies that it could soon be a large presence in the US equity market – and that its portfolio decisions could consequently affect the returns on a range of financial assets. Some believe its power is limited. Private investors will move to take advantage of any deviation from fair market value created by Chinese demand for some assets rather than others by selling the assets China is buying and buying the assets China is neglecting. Others though worry that the market also has an incentive to bid up assets that China may want to buy – and thus that Chinese demand could contribute to market mispricing. In either context, China's portfolio decisions will have a growing impact on the US equity market – not just the Treasury and Agency market.

So long as China's government has an effective monopoly on outward Chinese investment flows, the growth of Chinese investment in the US implies the growth of Chinese government investment in the US – and the prospect that a foreign government will own sizeable stakes in a number of US firms. This concern is not unique to China, but no other country has the potential to be quite as large a source of financing for corporate America. in 2006, China could have added close to \$600b to its foreign portfolio and possibly more that \$400b to its US portfolio – with maybe \$10b in US equity stakes and more like \$390b of bonds. If the pace of Chinese foreign asset accumulation continues at its current pace and a similar portion continues to be invested in the US, Chinese equity ownership could top $1 trillion in less than three years. Such an outcome is unlikely, but it is not impossible.

The CIC's investment strategy though is not just an issue for the US. It is likely to create more acute dilemmas for other emerging Asian economies. The CIC's initial investment mandates suggest a strong interest in investing in other emerging economies – and particularly in other emerging Asian economies. Yet many other Asian currencies are already attracting more private inflows than required to finance their existing currency account deficits. They also worry that allowing their exchange rate to appreciate would allow Chinese goods to undercut their own goods – both at home and in export markets. India is a case in point: the rupee's early 2007 appreciation is one reason why Chinese exports to India have increased at a 60% annual pace. India's reserve bank is already struggling to sterilize large private inflows; the last thing it wants is to sterilize large Chinese inflows as well.

China's neighbors are unlikely to be pleased if China's portfolio decisions put pressure on their currencies to appreciate (or pressure on their central banks to intervene, and effectively buy the dollars and euros China no longer wants), allowing Chinese producers to gain at their expense. Similarly, Europe is unlikely to welcome a major shift in China's portfolio that puts additional upward pressure on European currencies. Even if the CIC refrains from making non-commercial investments in individual firms, it is hard to see how its investment choices do not generate political friction. China is so large a player that its moves will shape a broad range of market outcomes. At times markets may offset the actions of the CIC, selling any asset that China has pushed above fair market value. At other times, though, the markets may seek to buy what China is expected to buy, and thus profit from (expected) Chinese demand and in the process reinforcing China's market impact.

In some ways, though, the CIC's portfolio investment abroad – assuming that the CIC is primarily a portfolio manager and it refrains from taking additional large stakes in US/ European financial institutions as well as refrains from taking stakes that cross key thresholds for control – is likely to produce less controversy than the outward expansion of China's cash–rich state firms. The CIC lacks the capacity to manage controlling stakes in a large number of firms. Ambitious managers of Chinese state firms do not face a similar constraint. The CIC is likely to want to avoid controlling stakes; Chinese state firms may want controlling stakes.

And CIC is likely to generate fewer concerns that outward expansion of Chinese state firms. Chinalco's roughly $13b investment – supplemented by $1.2b from Alcoa -- in Rio Tinto is a case in point. Chinalco and Alcoa combined to buy 9% of all of Rio Tinto's outstanding shares, effectively either blocking BHP Billiton's takeover bid unless BHP raises its offer significantly. This investment did not draw on financing from the CIC – though the CIC is supposedly interested in a large stake in another Australian iron ore company.

The precise dividing line between the activities of the CIC and the rest of the China's state though isn't at all clear: Chinalco financed its Rio Tinto stake by borrowing from the China Development Bank (CDB). The CDB was recently recapitalized with $20 billion from the CIC. The CIC in turn received a large equity stake in the CDB. So long as the CIC retains large stake in China's state banks, it will be hard to draw a line between the activities of China's state banks and the CIC.

Conclusion

In his testimony before the Senate Banking Committee, former Treasury Assistant Secretary Edwin Truman noted that the "dramatic increase in the role of governments in the ownership and management of international assets" was "disquieting" to the US, as "it calls into question our most basic assumptions about the structure and functioning of economies and the international financial system …. We presume that most cross-border trade and financial transactions will involve the private sector on both ends of the transaction. Unfortunately, our orientation is not congruent with certain facts, and we are being called upon to recalibrate out understanding of the world."

That is particularly true with respect to China. China's economic success is often attributed to its embrace of the market. Directionally, that is no doubt true. However, the structure of its economy remains quite different from the structure of the US and European economies. Chinese state-owned enterprises and state-owned banks have a far large role in the US – and as a result, the expansion of Chinese firms abroad likely will imply the expansion of state-owned firms abroad. Moreover, China's exchange rate regime has effectively given the China's state – in all of its forms – a monopoly on the outward flow of funds from China. Private investors would prefer to invest in China and benefit from the expected appreciation of the RMB, not invest abroad and try to eke out positive returns in the face of the expected depreciation of the euro and the dollar against the renminbi.

China is now the largest foreign investors – in both stock and flow terms – in the US – though given difficulties measuring China's rapidly growing claims on the US in real time, this is hard to confirm. Almost all of that investment is held by China's government in one form or another. So long as China confined its investment to bonds, though, the US did not have to worry about China's potential to exert direct control over US assets – though the scale of Chinese bond purchases no doubt gave it the capacity to move markets Judging from the returns China received in 2007, at least in RMB terms, Chinese purchase of US treasuries were motivated by a desire to manage its exchange rate, not by commercial returns. Few though complained.

However, China's government has made a strategic decision to encourage outward investment by Chinese firms, and to reorient the composition of the portfolio of China's central government toward equities. China, quite rightly, argues that it makes little sense for China to invest the funds that it receives from foreign direct investment in low yielding government bonds. The roughly $30b in outward direct investment by Chinese firms in 2007 will be far smaller from the over $80b in inward direct investment by foreign firms in China – or for that matter the $280b US firms have invested abroad over the last four quarters. On a stock basis, the discrepancy is even larger. Chinese direct investment abroad at the end of 2006 totaled $82.4b, while foreign direct investment in China totaled $544.2b. Foreign portfolio equity investment in China was $106.5b at the end of 2006, Chinese portfolio equity investment abroad was $1.5b.[7] Foreign holdings of Chinese debt, though, only totaled $14b, while Chinese holdings of foreign debt – counting Chinese reserve holdings, totaled close to $1300b. That total likely increased to around $1800b by the end of 2007.

China's desire to diversify the composition of its portfolio though runs squarely into the United States historic aversion to government ownership of private firms. The most obvious ways of minimizing the associated friction – for example, Chinese investment in index funds rather than individual companies – run directly into China's strong desire, also rooted it its historical experience, not to compromise its sovereignty. It also runs against the self-interest of cash-strapped US firms – whether capital-short broker -dealers or US metals companies -- who are increasingly seeking looking to do deals with China's government. China is, so to speak, where the money is. So long as the US saves far less than it invests, China saves more than it invests and China's government accounts for the lion's share of the increase in China's foreign assets, some part of the US economy will either be borrowing from China's government or selling equity to China's government.

In the long-term, the US and China would both benefit if their current financial interdependence fell. The United States ability to draw on financing from other governments – financing that has increased as private demand for US financial assets, relative to private US demand for asset abroad – has broadly speaking been stabilizing. But it also implies a rising level of government participation in US financial markets and, as governments shift from a bond heavy portfolio to a more balanced portfolio – rising government ownership of US companies. And the investment of so much of China's savings – Chinese claims on the US are probably equal to about a third of China's GDP – raises equally profound questions, not the least because such investment is unlikely to generate strong financial returns in the RMB terms. A world with a smaller US deficit financed by private flows would generate less tension. In the short-run, though, the challenges associated with United States financial interdependence on a country with a very different political and economic system – despite ongoing reforms – look set to rise.

[7] The stock of US FDI abroad – valued at current cost – was $2855.6 billion at the end of 2006, far larger, relative to US GDP, than Chinese FDI abroad. US portfolio equity holdings totaled $4251b.

Chart 1

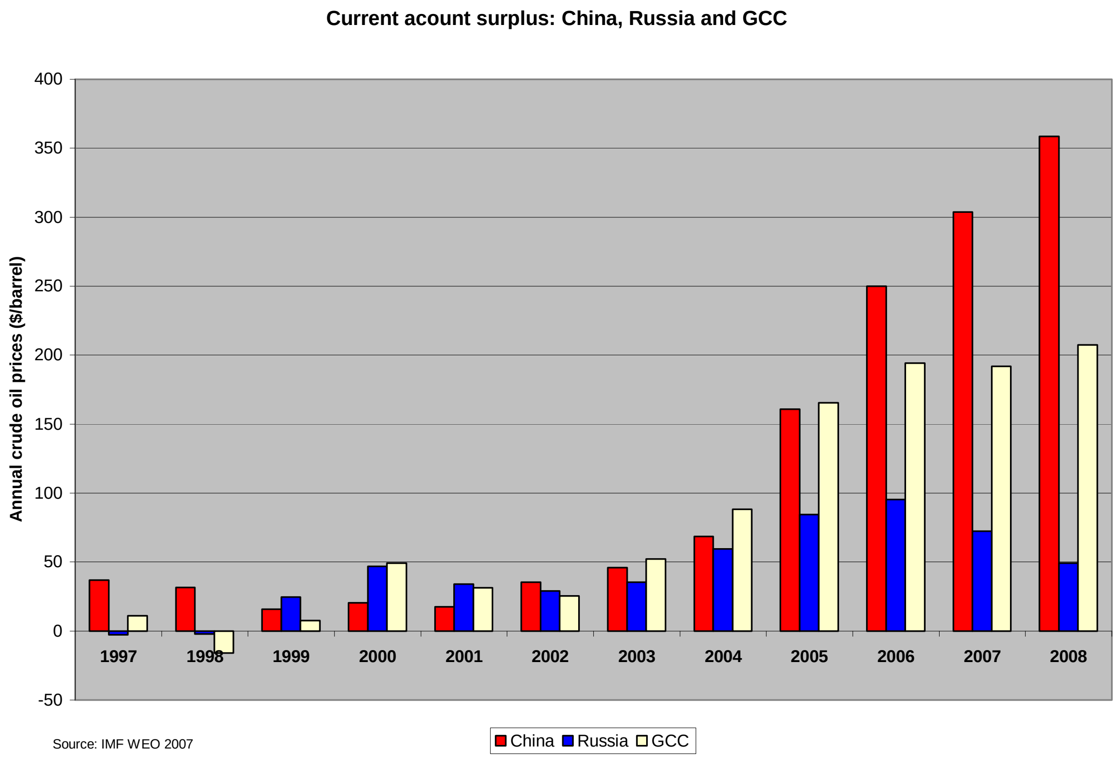

Table 1. Foreign assets of China's government

	Total foreign assets	2007 increase
Identified assets of China's government		
State administration of foreign exchange (SAFE)	$1,528b	$427b
China Investment Corporation (CIC), estimated foreign assets	$17b	$17b
State banks estimated fx liabilities to the central government – recapitalization/ swaps[8]	$221b	$60b
Subtotal (identified assets)	$1776b	$504
Possible additional foreign exchange holdings		
Banks' required reserves (held in dollars)	$108b	$108b
Foreign assets of state enterprises	?	?
Total (high-end estimate)	$1884b	$612

[8] The foreign assets of the banks have been estimated from their estimated foreign currency liabilities to the Chinese government. The banks recorded portfolio investment abroad is somewhat smaller: $166b at the end of November, 2007 -- down from $180b at the end of December 2006.

Chart 2

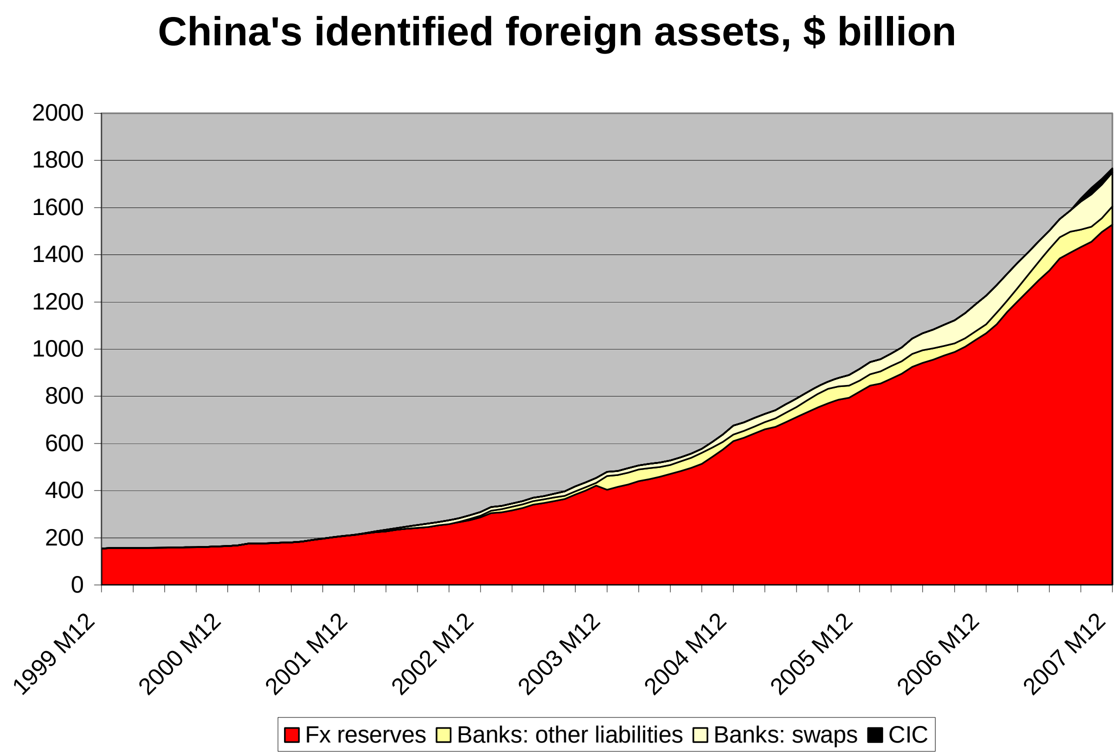

Chart 3

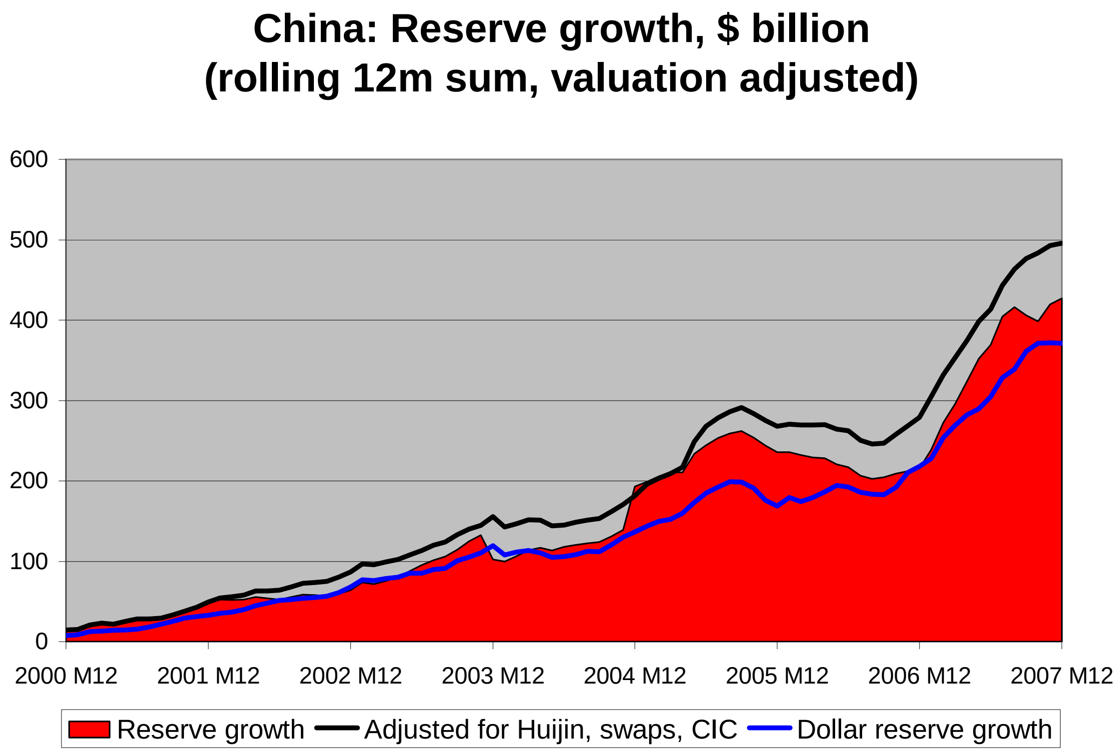

Chart 4: foreign asset growth, accounting for potentially large increase in assets of the state banks

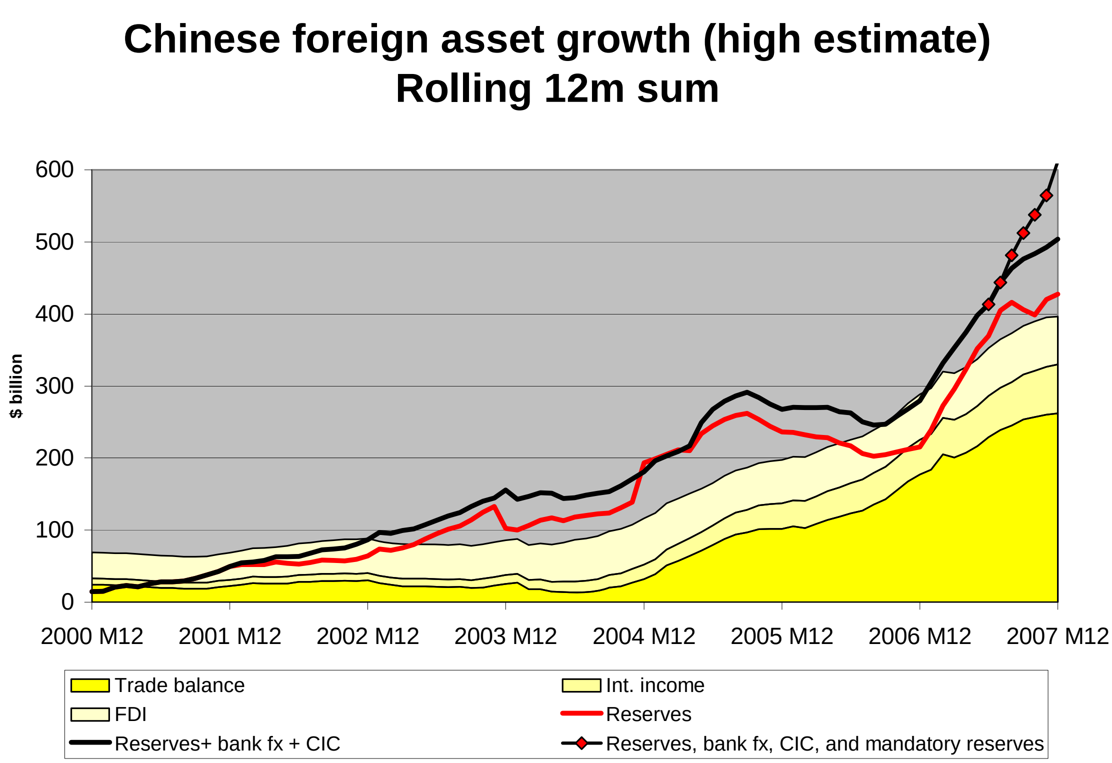

Chart 5

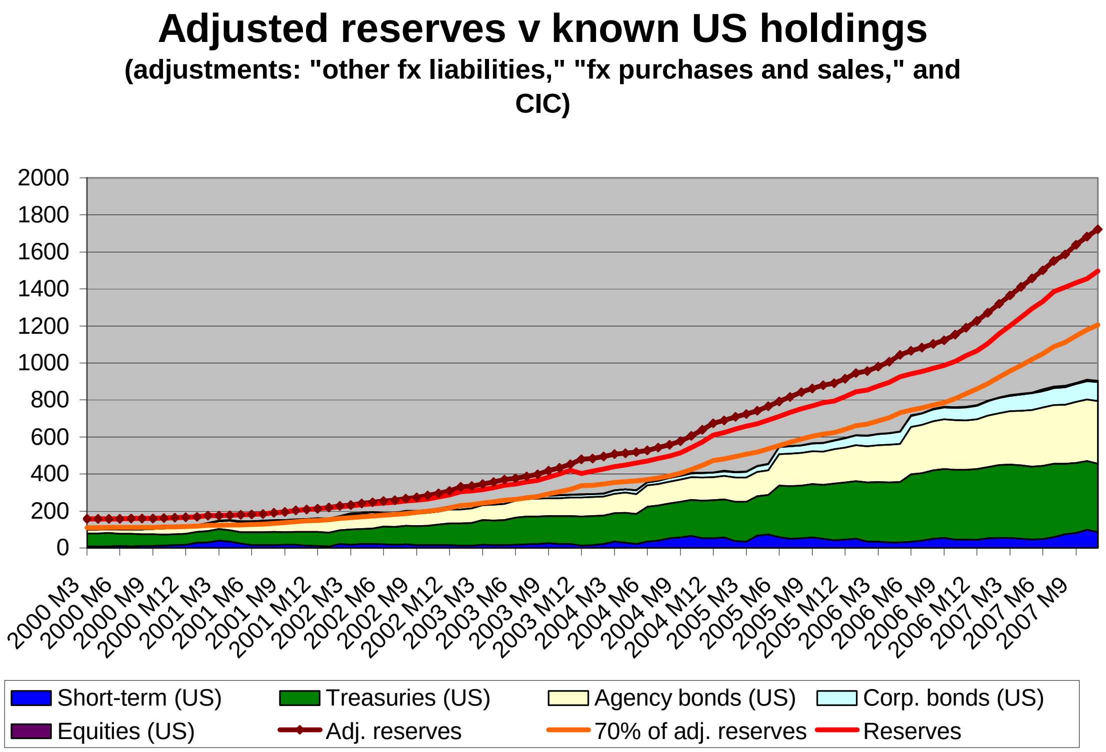

Chart 6: Transparency

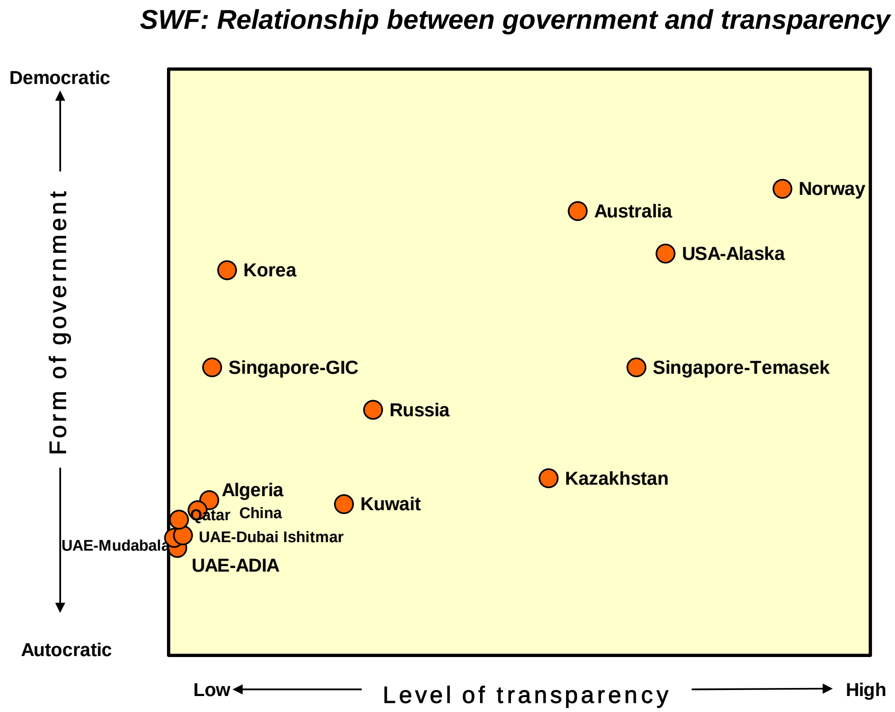

Chart 7: Per capita GDP of SWF host countries